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In the Supreme Court of the United States

OCTOBER TERM, 1986

ROTH STEEL TUBE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner contends that the court of appeals erred in affirming the disallowance of certain claimed bad debt and loss deductions.

1. In 1972, petitioner paid $553,062 to acquire 62% of the stock of Remco Industries, Inc. (Remco), a toy manufacturer. Remco was undercapitalized and had sustained substantial losses, which had caused it to file in 1971 for protection under the Bankruptcy Act. Pet. App. A2, A20. In 1972 and 1973, petitioner made unsecured advances in the amount of $2,832,150 to Remco to be used as working capital.[1] No notes were executed with respect to the advances, which were reflected as receivables on petitioner's

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[1]In addition, $587,850 was advanced to Remco on behalf of another of petitioner's subsidiaries, Roth Properties, Inc. That amount was discharged in 1973 in connection with Remco's sale to Roth Properties of one of its operating facilities (Pet. App. A5).

books. No interest was ever charged or paid on these advances. *Id.* at A5-A6. Any repayment obligation was generally dependent on future profits; except for a $10,000 repayment made in September 1973, none of the advances were in fact repaid (*id.* at A5). Remco ceased operations in January 1974, at which point its remaining assets were turned over to a third-party creditor. On its 1974 tax return, petitioner claimed a bad debt deduction for its advances to Remco and a loss deduction for its investment in the Remco stock. *Id.* at A5-A7.[2]

2. The Commissioner determined that petitioner's advances to Remco were contributions to capital, not loans, and thus that petitioner was not entitled to any bad debt deduction for them. He also determined that the losses from petitioner's stock investment in Remco were capital in nature and therefore were deductible only to the extent of capital gains, of which petitioner had none. Accordingly, the Commissioner disallowed the deductions and determined deficiencies in petitioner's income taxes. Pet. App. A7-A8, A33.

Petitioner sought redetermination of the deficiencies in the Tax Court, which upheld the Commissioner's determination in full (Pet. App. A18-A51; 49 T.C.M. (CCH) 698). Examining several factors, the Tax Court found that "the overwhelming weight of the evidence * * * leads us to the conclusion that the advances were capital contributions to Remco" (Pet. App. A44). The court also found that petitioner had purchased the Remco stock as an investment and therefore rejected petitioner's claim that the loss sustained with respect to the stock was not capital in nature (*id.* at

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[2]This resulted in a net operating loss for which petitioner claimed carryover deductions in prior and subsequent years (Pet. App. A7).

A35-A39).[3] Subsequently, the Tax Court denied petitioner's motion to vacate or revise its decision, reaffirming its original ruling (*id.* at A53-A60). The court emphasized that "[i]t is inescapable that Remco's debt capability was fully absorbed by third party creditors, and loans by petitioner could be nothing else but capital infusion" (*id.* at A60).

The court of appeals unanimously affirmed (Pet. App. A1-A17; 800 F.2d 625). It examined 11 different factors that the courts have traditionally used in deciding whether ambiguous payments represent equity investments or loans (*id.* at A9-A15). The court found that only two of the factors supported petitioner's contention that the advances were debt, whereas the other nine factors pointed to the conclusion that the advances were capital contributions. "[C]onsidering all the factors," the court of appeals labeled as not "clearly erroneous" the Tax Court's conclusion that the advances were capital contributions rather than bona fide loans (*id.* at A15). Petitioner also argued for the first time on appeal that its loss on the securities should be an ordinary loss on the theory that the Remco shares were worthless shares of an "affiliated corporation." See Section 165(g)(3) of the Internal Revenue Code (26 U.S.C.). The court of appeals declined to consider this issue, pointing out that petitioner had failed to raise it in the Tax Court and

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[3]Petitioner had argued that its purchase of Remco stock was not for investment purposes and hence that the loss should be treated as an ordinary loss under *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46 (1955). See, *e.g.*, *Booth Newspapers, Inc.* v. *United States*, 303 F.2d 916 (Ct. Cl. 1962) (holding that common stock in certain circumstances can be regarded as a non-capital asset). But see *Arkansas Best Corp.* v. *Commissioner*, 800 F.2d 215 (8th Cir. 1986), petition for cert. pending, No. 86-751 (rejecting *Booth Newspapers*). As petitioner acknowledges (Pet. 8-9), it abandoned this argument in the court of appeals, and it has not renewed the argument in this Court (see Pet. [I]). Accordingly, the so-called "*Corn Products* doctrine" has no bearing on the instant petition, and there is no reason to hold this case pending disposition of *Arkansas Best*.

that "resolution of the issue would require further factual determination" (*id.* at A15-A16).

3. a. Petitioner contends (Pet. 12-15) that the Court should grant certiorari here to resolve a supposed conflict in the circuits about how debt/equity questions should be characterized for purposes of appellate review. The Sixth Circuit panel in this case stated that the determination whether an advance is "equity" or "debt" is "a question of fact" subject to review under "the clearly erroneous standard." Pet. App. A9; see *Smith* v. *Commissioner*, 370 F.2d 178, 180 (6th Cir. 1966). Conversely, the Fifth Circuit has stated that this "evaluation is primarily a question of law, and a district court's determination of the issue is thus subject to de novo review." *Estate of Mixon* v. *United States*, 464 F.2d 394, 402-403 (1972); see also *In re Lane*, 742 F.2d 1311, 1315 (11th Cir. 1984). Other circuits have variously characterized the determination as a "question of fact,"[4] as "essentially a question of fact,"[5] and as a "mixed question of law and fact."[6] Different panels of the same circuit—including the Sixth Circuit—have routinely described the exercise in contrasting ways.[7] And the courts

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[4]*E.g., Diamond Bros.* v. *Commissioner*, 322 F.2d 725, 730 (3d Cir. 1963); *Road Materials, Inc.* v. *Commissioner*, 407 F.2d 1121, 1123-1124 (4th Cir. 1969).

[5]*E.g., Brake & Electric Sales Corp.* v. *United States*, 287 F.2d 426, 428 (1st Cir. 1961); *Gilbert* v. *Commissioner*, 262 F.2d 512, 513-514 (2d Cir.), cert. denied, 359 U.S. 1002 (1959).

[6]*E.g., Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963).

[7]Compare *Scriptomatic, Inc.* v. *United States*, 555 F.2d 364, 372 n.13 (3d Cir. 1977) (question of law), with *Diamond Bros.* v. *Commissioner*, 322 F.2d at 730 (question of fact); and compare *Ragland Investment Co.* v. *Commissioner*, 435 F.2d 118, 120 (6th Cir. 1970) (question of fact), with *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970) (question of law preferable); and compare *A. R. Lantz Co.* v. *United States*, 424 F.2d 1330, 1334 (9th Cir. 1970) (question of fact), with *Taft* v. *Commissioner*, 314 F.2d 620, 622 (9th Cir. 1963) (mixed question of law and fact).

have regularly responded to this apparent diversity of views by observing that the outcome would be the same regardless which view were adopted.[8]

This Court recently declined to grant certiorari to resolve this supposed conflict in the circuits. *Texas Farm Bureau* v. *United States*, 469 U.S. 1106 (1985). As we pointed out in our memorandum opposing certiorari there (84-276 U.S. Mem. 5-7),[9] the "conflict" posited by petitioner is far more apparent than real. The diverse verbal formulations adopted by the courts of appeals reflect the obvious fact that debt/equity questions involve a melange of "factual" and "legal" considerations. Once the operative facts are established, the court must analyze those facts under the relevant legal criteria—the 11-factor "laundry list" used by the court of appeals here—according each factor its proper weight and balancing one against the other to determine the proper legal characterization of the instrument involved. See, *e.g.*, *Austin Village, Inc.* v. *United States*, 432 F.2d 741, 744 (6th Cir. 1970). Under these circumstances, it is not likely to make any difference whether the court of appeals approaches its task by asking whether the trial court drew the correct inference of ultimate fact, subject to review under the "clearly erroneous" standard, or by asking whether the trial court analyzed the undisputed facts under the correct legal criteria, applying no irrelevant factors and avoiding undue emphasis on one factor to the exclusion of others. See, *e.g.*, *In re Uneco, Inc.*, 532 F.2d 1204, 1209-1210 (8th Cir. 1976); *Austin Village*, 432 F.2d at 745; *Piedmont Minerals Co.* v. *United States*, 429 F.2d 560, 562 & n.4 (4th Cir. 1970); *A. R. Lantz Co.* v. *United States*, 424 F.2d 1330, 1333-1334 (9th

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[8]See, *e.g.*, *Austin Village*, 432 F.2d at 745; *Lundgren* v. *Commissioner*, 376 F.2d 623, 625-626 (9th Cir. 1967).

[9]We are furnishing petitioner's counsel with a copy of that memorandum.

Cir. 1970); *Brake & Electric Sales Corp.*, 287 F.2d 426, 428 (1st Cir. 1961). In short, whether the question should be styled one of fact or of law is a matter of little more than philosophical interest.

b. In any event, even if there were thought to be a genuine "conflict in the circuits" on this issue, the instant case would not present an opportunity for the Court to resolve it. Petitioner's advances to Remco would plainly be characterized as capital contributions by any circuit, under any standard of review. Thus, resolution of the supposed conflict would have no bearing on the outcome of this case.

The court of appeals analyzed petitioner's advances to Remco by reference to 11 factors, including the presence or absence of a fixed maturity date; the presence or absence of a fixed rate of interest; the source of repayments, if any; the adequacy of capitalization; the security for the advances; the corporation's ability to obtain third-party loans; the presence or absence of subordination; the uses to which the advances were applied; and the presence or absence of a sinking fund to provide repayments. These are the factors that have commonly been recognized as relevant by the courts of appeals.[10] The Sixth Circuit here found (Pet. App. A12-A15) that virtually every relevant factor supported the

[10]This Court recently denied certiorari in *Piggy Bank Stations, Inc.* v. *Commissioner*, 755 F.2d 450, 454 (5th Cir. 1985), cert. denied, No. 85-22 (Oct. 7, 1985), despite a taxpayer's protestations that the courts have applied these factors inconsistently. In actuality, the courts uniformly cite the same factors, stressing that the factors are not of equal weight and that no one factor controls. See *Casco Bank & Trust Co.* v. *United States*, 544 F.2d 528, 532 (1st Cir. 1976), cert. denied, 430 U.S. 907 (1977); *Gilbert* v. *Commissioner*, 248 F.2d 399 (2d Cir. 1957), on remand, 262 F.2d 512, 514, cert. denied, 359 U.S. 1002 (1959); *Fin Hay Realty Co.* v. *United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Jewell Ridge Coal Corp.* v. *Commissioner*, 318 F.2d 695, 699 (4th Cir. 1963); *In re Uneco, Inc.*, 532 F.2d 1204, 1208 (8th Cir. 1976); *Bauer* v. *Commissioner*, 748 F.2d 1365, 1368 (9th Cir. 1984); *Hayutin* v. *Commissioner*, 508 F.2d 462, 473 (10th Cir. 1974); *In re Lane*, 742 F.2d at 1314-1315; *Post Corp.* v. *United States*, 640 F.2d 1296, 1307 (Ct. Cl. 1981).

determination that petitioner's advances were capital contributions.

In particular, the court noted that Remco was seriously undercapitalized, with a debt-equity ratio in excess of 300 to 1. This factor, the court said, was "strong evidence" that the advances were capital contributions (Pet. App. A11-A12). The court also explained that there were no instruments of indebtedness, no fixed rate of interest, and no schedule of payments, all of which belied the argument that these advances were loans (*id.* at A12-A13). The court noted that petitioner's advances were unsecured and that there was no sinking fund to ensure repayment; rather, repayment could come only out of Remco's earnings (*id.* at A12-A14). "If the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution" (*id.* at A12). And the court pointed to the fact that Remco generally was unable to obtain outside financing, concluding that "[t]he fact that no reasonable creditor would have acted in the same manner as [petitioner] is strong evidence that the advances were capital contributions" (*id.* at A14).

Against this overwhelming evidence that petitioner's advances represented an equity investment, the court noted that only two factors—the non-pro-rata nature of the advances, occasioned by the fact that petitioner held only 62% of Remco's stock, and the fact that the advances were used for working capital rather than the purchase of long-term assets—could be read to support petitioner's desired characterization of the advances as loans. But it is not necessary to give any particular deference to the Tax Court's determination to conclude that it was correct in holding that these factors did not outweigh the massive evidence pointing in the opposite direction. See Pet. App. A44-A50. Accordingly, it is manifest that this case presents

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no occasion to decide whether the Tax Court's determination should be reviewed under the "clearly erroneous" standard or under a de novo standard of review.[11]

4. Petitioner also challenges (Pet. 16-17) the court of appeals' refusal to consider its contention that it was entitled to an ordinary loss deduction under Section 165(g)(3), a refusal based on the fact that petitioner had failed to advance this argument in the Tax Court. It is well established that the courts of appeals have discretion to decline to consider an argument not raised in the trial court. Indeed, particularly where, as here, the new argument would require additional factual inquiry (see Pet. 17 n.6; Pet. App. A16), the appellate court ordinarily should not consider such an argument in the absence of special circumstances not present here. See generally *Singleton* v. *Wulff*, 428 U.S. 106, 121 (1976). Because consideration of issues raised for the first time on appeal is generally committed to

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[11]Petitioner does not specifically contend that the courts below erred in finding the advances to be contributions to capital, but it does suggest in a footnote in the statement (Pet. 8 n.1) that the Fifth Circuit would view *either* of the last two factors discussed in the text as dispositive that the advances were loans, regardless of the evidence pointing the other way. This suggestion is plainly mistaken. The Fifth Circuit, like other circuits, has always taken the view that no one factor controls. See *Piggy Bank Stations, Inc.* v. *Commissioner*, 755 F.2d at 454. Indeed, it is not apparent that the Fifth Circuit would accord much weight at all to the non-pro-rata character of petitioner's advances, given the context of this case. While a substantial advance from a 15% shareholder may look more like a loan than a contribution to capital (see *Estate of Mixon* v. *United States*, 464 F.2d at 409), it is not uncommon for a majority stockholder like petitioner to make efforts, in which the minority shareholders are unwilling to join, to infuse capital into a failing corporation, thereby yielding a non-pro-rata contribution to capital. And when a corporation is so thinly capitalized that it lacks funds to pay its operating expenses, the fact that advances are used to pay those expenses is hardly inconsistent with characterization of the advances as contributions to capital.

the court's discretion (see, *e.g., ibid.; United States* v. *Manzella*, 782 F.2d 533, 546 (5th Cir. 1986), cert. denied, No. 85-6740 (May 19, 1986)), petitioner's citation of instances where a court of appeals has elected to consider such an issue (see Pet. 16-17) plainly does not establish a conflict in the circuits. Contrary to petitioner's assertion, the Fourth and Fifth Circuits adhere to the general rule that an appellate court ordinarily will not review an argument not raised below. See, *e.g., Furka* v. *Great Lakes Dredge & Dock Co.*, 755 F.2d 1085, 1089 (4th Cir. 1985); *Moore* v. *Commissioner*, 722 F.2d 193, 196 (5th Cir. 1984).[12]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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[12]We note incidentally that petitioner's underlying contention is totally without foundation. Section 165(g)(3) of the Code establishes as one prerequisite to its invocation that the taxpayer own at least 80% of the voting power of the "affiliated corportation." Petitioner owned only 62% of Remco's stock.